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Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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I

INTRODUCTION

This reply brief is submitted pursuant to leave granted by the Court at oral argument. It is made necessary by the taxpayers' failure to attempt to support the judgments below on the ground on which those judgments were rested and

their attempt to sustain the judgments on grounds upon which the court below found it unnecessary to pass.

In *Campbell* v. *United States*, 144 F. 2d 177, the court below announced two so-called exceptions to the rule of the *Sansome* case. The first asserted exception was put in these terms (144 F. 2d at 180):

> The identity of proprietary interest which existed in the Sansome case and motivated the court to disregard the corporate entities and treat the earnings of the predecessor corporation as though they were earnings of the successor corporation is, therefore, completely lacking. We think that for this reason alone the doctrine of the Sansome case, which by judicial construction operates to transfer earnings from the corporation which earned them to its successor in reorganization, is inapplicable.

The second so-called exception was thus described (144 F. 2d at 181):

> The doctrine of the Sansome case that the accumulated earnings of the predecessor corporation in a tax-free reorganization shall be deemed carried over to the successor corporation for the purpose of distribution to its stockholders as dividends cannot apply to a situation where the accumulated earnings of the predecessor corporation have been distributed to its stockholders at the time of the reorganization. Obviously

> earnings cannot at one and the same time be distributed to the stockholders of the predecessor corporation and transferred to the successor corporation.

In the cases at bar, the court below found it unnecessary to pass upon the applicability of the second "exception" described in its *Campbell* opinion "since this case is squarely under the first exception in Campbell" (R. 43, note 5).[1] The only question presented in the petition to this Court upon which certiorari was granted and with respect to which the Government seeks a ruling is, as there stated (p. 2):

> Whether the so-called *Sansome* doctrine, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders acquire, for cash, a stock interest in the successor corporation.

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[1] It is clear that the sentence from the opinion of the court below (R. 44) quoted by taxpayers in their brief (p. 9), and which they assert "explains the grounds of its decision," was merely descriptive and not intended in any way to limit the lower court's holding that the case is squarely under the first exception in *Campbell*. Indeed, this plainly appears from the sentence in the opinion immediately following that quoted by taxpayers, reading as follows (R. 44):

> The Tax Court recognizes that the facts are directly within the first branch of the Campbell decision but contends for the general application of the Sansome principle.

It was this question, the propriety of refusing to apply the *Sansome* doctrine on the grounds described by the court below as the "first exception in Campbell" (R. 43, note 5), that was the subject of the Government's main brief in this Court. Taxpayers, however, both in their brief, and on oral argument, rested their case not on the "first exception," but, instead, principally patterned their contentions on the "second exception" in *Campbell*. See, in particular, Br. 15.

We believe that it would be inappropriate for this Court to reach the issue now posed by the taxpayers. The parties and the Court have not had the benefit of the views of the court below on this issue, and, under such circumstances, a remand would seem to be required after this Court answers the question presented by the petition for certiorari. *United States* v. *Ballard*, 322 U. S. 78, 88. The conclusion that this course would be the better one is buttressed by the fact, noted by the dissenting judge below (R. 46), that the findings of the Tax Court do not supply a wholly adequate foundation for the resolution of the issue now mooted by the taxpayers.

We propose, in this brief, to support our assertion that a remand is required by the lack of crystallization of the issues and the absence of adequate Tax Court findings. We think that our discussion will also show that these cases cannot be decided without a ruling on the question pre-

sented in the petition for certiorari, since even the record as now made indicates that there is little substance to the taxpayers' contention that the cases can be entirely disposed of on the grounds upon which taxpayers now rest.

As discussed below, we do not agree with the Tax Court's holding that whether or not a given corporate distribution effects a distribution of earnings and profits, within the meaning of Sections 112 (c) (1) and (c) (2) of the Revenue Act of 1928, depends upon the total amount of gain reported by the individual stockholders as the result of the reorganization exchange (R. 26). We consider the correct rule to be that the nature and extent of the distribution is to be viewed from the standpoint of the corporation making the distribution, and not from that of the individual stockholders. Among the issues which the Tax Court may consider on remand, are: (a) whether the accumulated earnings (without regard to Crandall earnings and considering those of Henderson, Inc., alone), considering the purchase by New Corporation of 11,078 shares of its outstanding stock between December 4, 1928, and December 31, 1939, the liquidation or additional purchase of 12,805 shares in 1940, and the possibility of loss up to June, 1940, were sufficient to cover the June, 1940, distribution sought here to be taxed; (b) the extent to which the amount paid to Crandall stockholders (not participating in the reorganization)

in partial liquidation was, under the terms of Section 115 (c) of the Revenue Act of 1928, properly chargeable to capital account and did not constitute a distribution of earnings or profits; (c) if any sums are to be regarded as received by Crandall stockholders as "boot," whether its distribution effected a distribution of earnings and profits.

Thus, if this Court agrees with the Government's contention that, where there is a reorganization within the meaning of the nonrecognition provisions of the federal tax statutes, the introduction of new cash into the corporate picture does not prevent the application of the *Sansome* principle, then we believe that the appropriate disposition of these cases will be to remand them to the Tax Court, in order that a determination may be made whether the new company had sufficient earnings and profits, including such earnings as were transferred from the old corporations, to cover all or any part of the distribution of $35,166.25 made by the new corporation on June 19, 1940, which is in issue.

II

THE AVAILABILITY OF EARNINGS AND PROFITS

The Tax Court has held that all of the earnings of both of the old corporations were transferred to the new corporation (R. 27). The court below held that the *Sansome* principle is inapplicable

and that none of the earnings of the old corporations were transferred to the new (R. 44). If the *Sansome* rule applies to these cases, then, obviously, all of the Henderson, Inc., earnings were transferred to the new corporation, for Henderson, Inc., and its stockholders received only stock upon the reorganization. We believe it to be equally clear that at least some part of Crandall's earnings were transferred to the new corporation. In any event, the conclusion is possible in these cases that even if the earnings of Henderson, Inc., alone were transferred to the new corporation, there were sufficient available earnings and profits in the hands of the new corporation on June 19, 1940, to cover the entire distribution made by the new corporation on that date. To reach that conclusion, however, would require, as we shall point out hereinafter, a decision of several issues which have not been passed upon either by the Tax Court or the court below. Resolution of these issues will likewise determine to what extent, if any, Crandall's transferred earnings must be taken into account to produce an amount sufficient to cover the June 19, 1940, distribution which is in question.

A. EARNINGS AND PROFITS OF THE NEW CORPORATION, AVAILABLE FOR DISTRIBUTION ON JUNE 19, 1940, TAKING INTO ACCOUNT ONLY THE TRANSFERRED EARNINGS OF HENDERSON, INC.

The New Corporation, on June 19, 1940, distributed $35,166.25 to its common shareholders.

Out of this sum the taxpayers together received $25,000. (R. 21.) We think it clear that part of this $25,000, if not the whole, was made up of earnings and profits: *First:* Between December 4, 1928, the date of the reorganization, to December 31, 1939, the New Corporation had earnings and profits of $401,470.07, as against distributions of only $369,452.30. (R. 22.) This left earnings of $32,017.77, which had not been distributed as of January 1, 1940. The company lost $37,252.47 in 1940; and the extent to which this loss affected earnings available for the June 1940 distribution has not been determined (R. 46).

Second: Between December 4, 1928, and December 31, 1939, the New Corporation also acquired 11,078 shares of its own stock for $72,211.13. (R. 22.) This purchase probably did not diminish the New Corporation's earnings, for neither the stipulation nor the Tax Court's finding indicates that these shares were cancelled or redeemed and the record points to the conclusion that they were not. *Amelia H. Cohen Trust* v. *Commissioner,* 121 F. 2d 689, 691 (C. C. A. 3d); *Dow Chemical Co.* v. *Kavanagh,* 139 F. 2d 42 (C. C. A. 6th); *Fox* v. *Harrison,* 145 F. 2d 521 (C. C. A. 7th); *Aviation Capital* v. *Pedrick,* 148 F. 2d 165 (C. C. A. 2d), certiorari denied, 326 U. S. 723. The transaction merely marks the conversion of one asset, cash, into another kind of asset, stock, held for investment. The New Corporation issued 50,000 shares upon its organization and no

other shares were ever issued (R. 14). Nevertheless, in March 1940, there were 11,078 shares of treasury stock outstanding (R. 21). *Third:* The New Corporation, in 1940, "liquidated or purchased" 12,805 additional shares of its own stock for $94,441.90 in cash (R. 22). The Tax Court did not determine whether the sums expended in this purchase should be subtracted from accumulated earnings and profits (R. 22, note 1). The court below likewise regarded the question as to whether the sums expended (R. 42, note 3)—

> in liquidating purchases should be subtracted from accumulated earnings and profits. * * * unnecessary to the decision below and * * * not important to the result arrived at here.

This question, too, may appropriately be determined by the Tax Court on remand.

While at the time of the reorganization, $355,247.75 in cash was distributed, no part of this amount came out of Henderson's earnings. On the contrary, the Tax Court found that all the assets of Henderson, Inc., were acquired by the

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The additional stipulation that (R. 9):

> Crandall-McKenzie & Henderson, Inc., at December 31, 1939, had no earnings or profits accumulated from December 4, 1928, to December 31, 1939, and it had no earnings or profits in its taxable year January 1, 1940, to December 31, 1940—

certainly does not mean that there was any *deficit* in accumulated earnings and profits of Crandall-McKenzie and Henderson, Inc., on December 31, 1939. See further our main brief, p. 6, note 2.

New Corporation solely in exchange for 9,524 shares of its stock, and that, at the time of this acquisition, Henderson, Inc., had earnings and profits of $74,763.62 accumulated subsequent to March 1, 1913. (R. 21.) Hence, without regard to Crandall earnings and considering those of Henderson, Inc., alone, a question is presented for the trier of the facts, as the dissenting judge in the court below indicated (R. 44) and as we have shown above, to determine whether the accumulated earnings were sufficient to cover the June 1940 distribution. If found sufficient, as we contend they are, or to the extent that there were earnings and profits available, what the petitioners received were dividends in accordance with the *Sansome* doctrine.

B. EARNINGS AND PROFITS OF THE NEW CORPORATION, AVAILABLE FOR DISTRIBUTION ON JUNE 19, 1940, TAKING INTO ACCOUNT CRANDALL'S TRANSFERRED EARNINGS

The Tax Court thought that it was sufficient here that taxpayers had not proved that any of the Crandall stockholders had realized a gain (R. 26–27), which was taxed to them under Sections 112 (c) (1) or (c) (2) of the Revenue Act of 1928, quoted in the footnote.[3] While the

[3] Revenue Act of 1928, c. 852, [illegible] at. 791:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this

record clearly supports the Tax Court's statement as to failure of proof, we do not agree with its holding that, whether or not a given corporate distribution effects a distribution of earnings and profits, is dependent upon the circumstance of whether a particular stockholder may or may not have realized a gain in his individual case. Our view is that the answer depends upon the nature of the distribution viewed from the standpoint of the corporation making the distribution. The stockholders of a given corporation may have acquired their stock at various times and at various prices. Under Section 112 (c) (1), the gain realized is measured by taking the difference between the sum of the "boot" and the fair

section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection, but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

market value of the new stock received and the cost or other basis of the old shares. Under that Section, however, the realized gain is taxable only in an amount equal to the cash received, and under Section 112 (c) (2) such portion of the taxable gain as does not exceed the stockholders' ratable shares of the earnings and profits of the corporation is treated as a dividend. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283. It is clear that the total gain reported by all of the stockholders participating in the reorganization may have little relation either to the amount of cash distributed or to the amount of earnings and profits of the distributing corporation. Moreover, to make the question, whether earnings and profits of the distributing corporation have been carried over, depend upon the total amount of gain reported by the stockholders as the result of the reorganization exchange, would create grave administrative difficulties and impose hardships on the successor corporation subsequently declaring dividends. Indeed, the corporation might not be able to secure information from its stockholders or former stockholders as to the amount of gain realized on the reorganization. The conclusion must necessarily be that the extent to which the distribution of "boot" effects the distribution of earnings and profits should not be determined by reference to the amount of gain that has been taxed to stockholders, and instruc-

tions to that effect should be given to the Tax Court upon a remand.

Taxpayers have not shown that the distribution of cash incident to the acquisition of the Crandall assets by New Corporation resulted in a distribution of all of Crandall's accumulated earnings and profits. It will be recalled that New Corporation acquired the Crandall assets for 14,607 shares of its own and $355,247.75 in cash (R. 21), and the cash and shares were distributed to Crandall shareholders.

According to the contentions made by taxpayers in their brief, this transaction is to be analyzed as follows (pp. 4–5):

> The holders of 1017.5 shares of Crandall, par value $10.00 per share, out of a total of 2060 shares, received $355,217.75 in cash in full for their 1017.5 shares. The holders of the remaining 1042.5 shares of Crandall received the 14,607 new company shares (and $30.00 cash) in exchange for their shares. * * *.
>
> O. McKenzie received 12,181 shares of the new company in exchange for 842½ shares of Crandall or 14.46 shares for one and J. L. Brown and A. J. Kapp each received 1,213 shares of the new company plus $15.00 for 100 shares of Crandall or 12.13 shares plus 15 cents for one. (R. 13–14.)
>
> A. E. Crandall received $300,000 in cash for 842½ shares of Crandall, or $356.00 plus per share and the holders of the re-

> maining 175 shares of Crandall received cash at the rate of $315.53 per share, as to 25 shares by sale to the new company and as to 150 shares from the liquidating trustees of Crandall. (R. 22, 12, 13.)

Hence, the effect of this analysis by taxpayers is that the only stockholders of Crandall who participated in the reorganization were Kapp and Brown and O. McKenzie, for they alone received shares of New Corporation stock in exchange for their Crandall shares; on the other hand, the remaining Crandall stockholders received only cash for their Crandall shares and in the aggregate amount of $355,217.75. Thus, the latter did not participate in the reorganization, and insofar as they were concerned there was a distribution in partial liquidation (Section 115 (h) of the Revenue Act of 1928) on which they were taxable as on a gain from a sale (Section 115 (c) of the Revenue Act of 1928). The extent to which such a partial liquidation effected a distribution of earnings and profits depends upon Section 115 (c) which, as shown in the footnote,[4] provides that the

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[4] Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under

portion of a distribution in partial liquidation properly chargeable to capital account is not to be considered a distribution of earnings and profits for the purpose of determining the taxability of subsequent distributions.

Moreover, in *Jarvis* v. *Commissioner*, 43 B. T. A. 439, affirmed, 123 F. 2d 742 (C. C. A. 4th), the Board of Tax Appeals and the Circuit Court of Appeals held that the amount of distribution in partial liquidation that is properly chargeable to capital account, is not only the par value of the shares redeemed, but also the paid in surplus chargeable to that stock and that only the balance of the distribution is chargeable to earnings.

Taxpayers in their brief (p. 13) completely fail to take this principle into account in the argument which they make with regard to the effect of the payment of cash in the amount of $355,217.75 (stated by taxpayers as $355,245.72) to the holders of 1017½ shares of Crandall stock. The principle represented by the *Jarvis* case should be applied here. It is true that the record indicates

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section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

that the 1017½ shares of Crandall had a par value of $10,175 (R. 9), but the record further establishes that Crandall had a large paid in surplus. Thus, New Company paid the amount of $649,991.80 according to its own valuation for assets of Crandall alone. (R. 12–13.) All of Crandall's 2060 shares represented a par value of $20,600. Its earned surplus, as has been seen, was $329,267.95. The difference between the sums of these amounts and $649,991.80 is in excess of $300,000. Besides, the distribution of earnings by the partial liquidation was not to 100% of Crandall stockholdings but to less than 50%, and hence only a proportionate part of the accumulated earnings and profits would be deemed distributed under Section 115 (c), i. e., no more than approximately $162,000. It appears therefore that a large part of the distribution to the dissenting stockholders necessarily represented a distribution of capital and paid in surplus and only part of the earnings. Thus, taxpayers have not established that even in the case of Crandall, the accumulated earnings were distributed prior to the June 1940 distribution here sought to be taxed.

Finally, if the analysis made by taxpayer of the Crandall distribution is not accepted by the Court, and it is deemed that A. E. Crandall had no part in the reorganization and that the $300,000 was paid to O. McKenzie together with 12,181

shares of New Corporation stock for 1,685 Crandall shares, 842½ of which he had independently purchased from A. E. Crandall, and hence, that the receipt of the $300,000 by McKenzie is to be considered "boot" under Section 112 (c) (1) and (c) (2) of the Revenue Act of 1928, it is our position that this distribution did not effect a distribution of earnings and profits to any extent, because it was not made pro rata. The situation is totally different from that involved in *Campbell* v. *United States, supra*, where the distributions were pro rata and the Court held as a second ground of decision that the earnings had been distributed in the reorganization. Further, even under this view of the facts, Ayer and Hasson and 104 other Crandall stockholders received no "boot" on an exchange of stock for stock, but were simply paid $55,217.75 for their shares in partial liquidation.* The extent to which such a transaction in partial liquidation effected a distribution of earnings and profits under Section 115 (c) of the Revenue Act of 1928 has already been discussed. Thus, on this view of the record also, the respondents have not established that earnings were distributed at the time of the reorganization.

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*The New Corporation purchased the Ayers and Hasson stock at $315.53 a share for $7,888.25 (R. 11–12) and the remaining 150 shares of Crandall stock belonging to 104 stockholders for $47,329.50 (R. 12–13).

CONCLUSION

The second ground of decision in the *Campbell* case certainly is not dispositive of the instant case, and this Court should decide this case, as did the court below, on the sole issue presented in the petition for certiorari, namely, the applicability of the *Sansome* rule to a situation in which new stockholders acquired for cash a stock interest in the successor corporation with consequent change in the proportionate interest of the old stockholders in the enterprise. The case, accordingly, should be remanded to the Tax Court with proper instructions. See *supra*, pp. 10–13.

Respectfully submitted.

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